



Virginia  
Regulatory  
Town Hall

## Final Regulation Agency Background Document

<b>Agency Name:</b>	Virginia Department of Taxation
<b>VAC Chapter Number:</b>	23-10-110
<b>Regulation Title:</b>	Individual Income Tax
<b>Action Title:</b>	Qualified Equity and Subordinated Debt Investments Tax Credit
<b>Date:</b>	January 16, 2002

Please refer to the Administrative Process Act (§ 9-6.14:9.1 *et seq.* of the *Code of Virginia*), Executive Order Twenty-Five (98), Executive Order Fifty-Eight (99), and the *Virginia Register Form, Style and Procedure Manual* for more information and other materials required to be submitted in the final regulatory action package.

### Summary

*Please provide a brief summary of the new regulation, amendments to an existing regulation, or the regulation being repealed. There is no need to state each provision or amendment; instead give a summary of the regulatory action. If applicable, generally describe the existing regulation. Do not restate the regulation or the purpose and intent of the regulation in the summary. Rather, alert the reader to all substantive matters or changes contained in the proposed new regulation, amendments to an existing regulation, or the regulation being repealed. Please briefly and generally summarize any substantive changes made since the proposed action was published.*

The Department of Taxation is proposing a new regulation pursuant to legislative action during the 1998 session of the General Assembly. The Qualified Equity and Subordinated Debt program is a new economic development tool to stimulate capital investment in small businesses located in the Commonwealth. The tax credit has a statewide cap of \$5 million. Individuals who invest in qualified businesses can earn a tax credit of up to 50% of their investment.

## Statement of Final Agency Action

*Please provide a statement of the final action taken by the agency: including the date the action was taken, the name of the agency taking the action, and the title of the regulation.*

---

On January 23, 2002, the department, effective for tax years beginning on and after January 1, 2001, adopted final regulations (23 VAC 10-110-225 through 229) for the Qualified Equity and Subordinated Debt Investments Tax Credit (Virginia Code § 58.1-339.4) (the "Credit").

## Basis

*Please identify the state and/or federal source of legal authority to promulgate the regulation. The discussion of this statutory authority should: 1) describe its scope and the extent to which it is mandatory or discretionary; and 2) include a brief statement relating the content of the statutory authority to the specific regulation. In addition, where applicable, please describe the extent to which proposed changes exceed federal minimum requirements. Full citations of legal authority and, if available, web site addresses for locating the text of the cited authority, shall be provided. If the final text differs from that of the proposed, please state that the Office of the Attorney General has certified that the agency has the statutory authority to promulgate the final regulation and that it comports with applicable state and/or federal law.*

---

Virginia Code § 58.1-203 authorizes the Tax Commissioner to promulgate regulations relating to the interpretation and enforcement of the laws of the Commonwealth governing taxes administered by the department. In addition, Virginia Code § 58.1-339.4(G) requires the department to promulgate a regulation governing the Credit program.

The Office of the Attorney General has certified that the agency has the statutory authority to promulgate the proposed regulation and it comports with applicable state law.

## Purpose

*Please provide a statement explaining the need for the new or amended regulation. This statement must include the rationale or justification of the final regulatory action and detail the specific reasons it is essential to protect the health, safety or welfare of citizens. A statement of a general nature is not acceptable, particular rationales must be explicitly discussed. Please include a discussion of the goals of the proposal and the problems the proposal is intended to solve.*

---

The department is promulgating a new regulation 23 VAC 10-110-225 et seq. governing the Credit program. An emergency regulation adopted by the department expired in February 2000.

The 1998 session of the General Assembly enacted Chapter 491 that established a new program in the Commonwealth to stimulate capital investment in selected small businesses. The Credit program provides for a maximum tax credit equal to 50% of the investment. The amount of the Credit that may be taken in any taxable year is limited to the lesser of the income tax imposed on the taxpayer for the taxable year, or \$50,000. The regulation sets forth the operating procedures of the program, including the process for applying for the Credit, what types of businesses are eligible or ineligible, and the procedures to be used to ensure that the dollar volume of tax credits requested for a given taxable year does not exceed the statutory limit of \$5,000,000.

The department has concluded that the regulation is essential for the efficient and economical performance of this economic development incentive. The regulation is necessary to comply with the statutory provisions of Virginia Code § 58.1-339.4. It is essential that the department promulgate a permanent regulation to outline the Credit application and allocation procedures for both qualified small businesses and their individual investors.

### Substance

*Please identify and explain the new substantive provisions, the substantive changes to existing sections, or both where appropriate. Please note that a more detailed discussion is required under the statement of the regulatory action's detail.*

The proposed regulation sets forth the procedures to be used to qualify for the Credit program. The program, effective for taxable years beginning on and after January 1, 1999, is designed to stimulate capital investment in selected small businesses that meet the statutory eligibility guidelines. The Credit available to a taxpayer in a taxable year is limited to the lesser of the tax imposed for the taxable year or \$50,000. Where the aggregate amount of the requested Credits for investments made in a calendar year exceed \$5 million, the department will allocate the available Credits pro rata among the approved Credit applicants. Unused Credits may be carried forward to offset future income tax liability for up to 15 taxable years.

### Issues

*Please provide a statement identifying the issues associated with the final regulatory action. The term "issues" means: 1) the advantages and disadvantages to the public of implementing the new provisions; 2) the advantages and disadvantages to the agency or the Commonwealth; and 3) other pertinent matters of interest to the regulated community, government officials, and the public. If there are no disadvantages to the public or the Commonwealth, please include a sentence to that effect.*

There are no disadvantages to the public or the Commonwealth as a result of the implementation of the new regulation.

**Statement of Changes Made Since the Proposed Stage**

*Please highlight any changes, other than strictly editorial changes, made to the text of the proposed regulation since its publication.*

---

The department has made changes to the following sections of the text of the proposed regulation since its publication:

**23 VAC 10-110-225 - Qualified Equity and Subordinated Debt Investments Tax Credit; Definitions.**

Amend definition of “qualified investment” to clarify the subordinated debt instruments that are convertible to equity could qualify for the credit.

**23 VAC 10-110-225 - Qualified Equity and Subordinated Debt Investments Tax Credit; Definitions.**

Amend definition of “subordinated debt” to clarify what constitutes a repayment of principal.

**23 VAC 10-110-228 B - Qualified Equity and Subordinated Debt Investments Tax Credit; Tax Credit Application Procedure**

Remove requirement that applications be sent by certified mail and add a provision allowing the department to specify the address where applications must be sent.

**23 VAC 10-110-228 E 2 - Qualified Equity and Subordinated Debt Investments Tax Credit; Tax Credit Application Procedure**

Delete subdivision E 2 and renumber subdivision E 3 as subdivision E 2. Insert references to the S corporation and its shareholders in the new subdivision E 2.

**23 VAC 10-110-229 D - Qualified Equity and Subordinated Debt Investments Tax Credit; Required Equity and Subordinated Debt Investment Holding Period**

Add a provision to describe how the required holding period applies to subordinated debt that is convertible into equity. Renumber subdivision D as subdivision E and subdivision E as subdivision F.

**23 VAC 10-110-229 F (subdivision E of the proposed regulation) - Qualified Equity and Subordinated Debt Investments Tax Credit; Required Equity and Subordinated Debt Investment Holding Period**

Add a reference that the department's authority to waive penalty for reasonable cause includes penalty accrued on subordinated debt investments.

The specific details of those changes are set forth under the heading "Detail of Changes."

### Public Comment

*Please summarize all public comment received during the public comment period and provide the agency response. If no public comment was received, please include a statement indicating that fact.*

During the public comment period on the proposed regulation, the law firm of McCandlish Kaine, Richmond, Virginia, submitted a letter of comments dated October 10, 2001 to the department addressing several concerns and making recommendations with respect to the proposed regulation, as follows:

1. Comment: 23 VAC 10-110-227 provides that a qualified business must apply prior to the issuance of any equity or subordinated debt. It is difficult for small businesses engaged in so-called "angel" financing to know the type and amount of financing until shortly before the closing of the financing. Businesses should be allowed a thirty-day period following the closing of a financing transaction in which to submit the application, pursuant to which the business applies for qualification for the tax credit program.

Department response: The Credit program is an economic development tool designed to stimulate capital investment in small businesses located in Virginia. In conjunction with this tool, the department's responsibilities focus on enabling individual investors to earn and claim the Credit and administering the \$5 million cap.

The Credit is an incentive offered to promote investment in small businesses that may not otherwise be able to obtain enough capital to be successful. In fashioning its regulations the department believes that the Credit should be a means of enticing potential investors. The upfront approval of businesses and their investments prior to issuance of qualified equity or subordinated debt allows the business to use the Credit as a means of attracting potential investors. Upfront approval provides assurance that the investment will qualify for the Credit.

So far, the requirement that the application be filed with the department ninety days (with certain limited exceptions) prior to issuance of a company's equity and/or subordinated debt does not appear to have created any disincentive to the robust use of the Credit. In each of the first two years since the Credit became effective, Credit requests have exceeded the \$5 million annual limit set by the General Assembly.

2. Comment: 23 VAC 10-110-227 provides that in order to be a qualified business, a business must identify the type of investment (equity or subordinated debt) to be issued when the application is made. A company qualified to participate in the Credit

program with an equity offering must submit another application if it wishes to qualify for a subordinated debt offering. This situation requires the small business to engage in a duplicate application process.

Department response: The application allows the company to signify, at the outset, a broad intention to issue either equity or subordinated debt, or both, and the certificate of qualification issued by the department to the company then extends to issue of either or both types of investment. It appears to be within the control of the company to avoid a duplicate application process by filing the application in that manner in the first instance.

3. Comment: 23 VAC 10-110-225 provides that subordinated debt by its terms cannot require any repayment of principal for the first three years after issuance. The regulation should specifically provide that an instrument that is redeemed or otherwise cancelled is not considered to be redeemed or cancelled for purposes of the tax credit program if the instrument is replaced by another qualifying instrument that is held by the investor for at least the remainder of the original applicable holding period.

Department response: Under Code of Virginia § 58.1-339.4, a subordinated debt instrument will not qualify if it includes a provision that requires any repayment that would be considered principal within three years of the date issue. The statute also sets forth the conditions under which an equity investment may be transferred before the expiration of the holding period without triggering a recapture of the Credit. The department believes that these conditions express the intent of the General Assembly that qualified businesses benefit from these sources of capital for the duration of the holding period. As such, the department would view any repayment of a qualified subordinated debt instrument before the expiration of the holding period as a trigger for recapture of the Credit unless such repayment occurs as a result of the liquidation of a qualified business, the merger or acquisition of such business with or by an unrelated third party, or the death of the taxpayer. For purposes of the holding period repayment restriction, repayment of principal would include any transaction the effect of which is to extinguish or to reduce outstanding subordinated debt, including, but not limited to:

- a. Reacquisition, retirement, or cancellation of a qualified investment;
- b. Refunding or refinancing by new issues of subordinated debt; or
- c. Exchange of subordinated debt for common or preferred stock.

The department has amended the definition of “subordinated debt” under 23 VAC 10-110-225 to clarify what constitutes a repayment of principal.

4. Comment: 23 VAC 10-110-229 E provides the department discretion to abate an assessed penalty if the taxpayer establishes reasonable cause for the failure to hold qualified equity for the full five calendar year holding period. Language should be

added to give the department similar discretion when the taxpayer has not held a subordinated debt instrument for the applicable three year period.

Department response: As with the holding period requirements, the department believes that it was the General Assembly’s intent to grant discretion to waive the penalty for failure to hold subordinated debt as well as equity. The department has included a reference to subordinated debt in the penalty abatement provision of the final regulations.

## Detail of Changes

*Please detail any changes, other than strictly editorial changes, that are being proposed. Please detail new **substantive** provisions, all substantive changes to existing sections, or both where appropriate. This statement should provide a section-by-section description - or crosswalk - of changes implemented by the proposed regulatory action. Include citations to the specific sections of an existing regulation being amended and explain the consequences of the changes.*

### **23 VAC 10-110-225 - Qualified Equity and Subordinated Debt Investments Tax Credit; Definitions.**

During the comment period the department received a request for a ruling concerning whether a convertible subordinated debt instrument could be a “qualified investment.” In Public Document 01-153 (10-17-01), the department indicated that it would allow convertible instruments would qualify under the following conditions:

- a. the subordinated debt would otherwise meet the definition under this section,
- b. the equity would otherwise meet the definition under this section, and
- c. the subordinated debt does not include a provision by which the issuer may compel the conversion into equity.

As a result of feedback received concerning provisions that permit issuers to force conversion of the instruments, the department has revised its position to allow forced conversion provisions provided an issuer may not compel the conversion into equity before the end of the required holding period.

### **23 VAC 10-110-225 - Qualified Equity and Subordinated Debt Investments Tax Credit; Definitions.**

As a result of comments received during the public comment period, the department determined that repayment of principal requirement for subordinated debt should be clarified. The department believes the intent of the General Assembly was to insure that qualified businesses benefit from capital provided through qualified investments for the duration of the holding period. As such, the department will consider any transaction the effect of which is to extinguish or to reduce outstanding subordinated debt as a repayment of principal, including, but not limited to:

- a. Reacquisition, retirement, or cancellation of a qualified investment;
- b. Refunding or refinancing by new issues of subordinated debt; or
- c. Exchange of subordinated debt for common or preferred stock.

**23 VAC 10-110-228 B - Qualified Equity and Subordinated Debt Investments Tax Credit; Tax Credit Application Procedure**

Remove requirement that applications be sent by certified mail and add a provision allowing the department to specify the address where applications must be sent.

**23 VAC 10-110-228 E 2 - Qualified Equity and Subordinated Debt Investments Tax Credit; Tax Credit Application Procedure**

Conform shareholder information requirements for S corporations to those required of partnerships and limited liability companies for partners and members, respectively.

**23 VAC 10-110-229 E - Qualified Equity and Subordinated Debt Investments Tax Credit; Required Equity and Subordinated Debt Investment Holding Period**

Subdivision E of the regulation as proposed gave the department discretion to abate an assessed penalty for any failure to hold qualified equity for the full five calendar year holding period. As a result of public comments, the department added a reference to subordinated debt to give the department similar discretion when the taxpayer has not held a subordinated debt instrument for the required three year period.

### Family Impact Statement

*Please provide an analysis of the regulatory action that assesses the impact on the institution of the family and family stability including the extent to which the regulatory action will: 1) strengthen or erode the authority and rights of parents in the education, nurturing, and supervision of their children; 2) encourage or discourage economic self-sufficiency, self-pride, and the assumption of responsibility for oneself, one's spouse, and one's children and/or elderly parents; 3) strengthen or erode the marital commitment; and 4) increase or decrease disposable family income.*

This regulation will have no effect on: 1) the authority and rights of parents in education, nurturing and supervision of their children; 2) the economic self-sufficiency, self-pride, and the assumption of responsibility for oneself, one's spouse, one's children, and/or one's elderly parents; 3) marital commitment; and/or 4) disposable family income.